

BEFORE THE
Federal Communications Commission
WASHINGTON, DC 20554

**ORIGINAL
RECEIVED**
NOV 23 1998

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

| | | |
|--|---|----------------------|
| In the Matters of |) | |
| |) | |
| 1998 Biennial Regulatory Review — |) | CC Docket No. 98-137 |
| Review of Depreciation Requirements for |) | |
| Incumbent Local Exchange Carriers |) | |
| |) | |
| United States Telephone Association Petition for |) | ASD 98-91 |
| Forbearance From Depreciation Regulation of |) | |
| Price Cap Local Exchange Carriers |) | |

COMMENTS OF U S WEST, INC.

James T. Hannon
U S WEST, Inc.
Suite 700
1020 19th Street, N.W.
Washington, D.C. 20036
(303) 672-2860

Its Attorney

Of Counsel,
Daniel L. Poole
U S WEST, Inc.

Kathryn A. Zachem
J. Wade Lindsay
Wilkinson, Barker, Knauer & Quinn LLP
2300 N Street, N.W.
Washington, D.C. 20037
(202) 783-4141

No. of Copies rec'd _____
List A B C D E _____

Date: November 23, 1998

Table of Contents

| | | |
|------|---|----|
| I. | INTRODUCTION/SUMMARY | 1 |
| II. | DEPRECIATION REGULATION SHOULD BE ELIMINATED | 3 |
| | A. Depreciation Regulation of Price Cap LECs is no Longer Justified | 4 |
| | B. Depreciation Regulation Does Not Serve Other Regulatory Purposes | 6 |
| | C. Permitting LECs to set Their Depreciation Rates Would Serve the Public Interest | 9 |
| III. | THE COMMISSION SHOULD FORBEAR FROM DEPRECIATION REGULA- TION OF PRICE CAP LECS | 13 |
| IV. | CONCLUSION | 16 |

BEFORE THE
Federal Communications Commission
WASHINGTON, DC 20554

| | | |
|--|---|----------------------|
| In the Matters of |) | |
| |) | |
| 1998 Biennial Regulatory Review — |) | CC Docket No. 98-137 |
| Review of Depreciation Requirements for |) | |
| Incumbent Local Exchange Carriers |) | |
| |) | |
| United States Telephone Association Petition for |) | ASD 98-91 |
| Forbearance From Depreciation Regulation of |) | |
| Price Cap Local Exchange Carriers |) | |

COMMENTS OF U S WEST, INC.

U S WEST, Inc. ("U S WEST") hereby submits the following comments regarding the Commission's review of depreciation requirements for incumbent local exchange carriers ("LECs"). U S WEST also submits comments supporting the petition for forbearance from depreciation regulation of price cap local exchange carriers filed by the United States Telephone Association ("USTA").

I. INTRODUCTION/SUMMARY

On September 21, 1998, USTA filed a petition under Section 10(c) of the Communications Act ("Act") requesting the Commission to forbear from regulating the depreciation and amortization practices of price cap LECs.¹ The *USTA Petition* demonstrates that depreciation regulation for price cap LECs is no longer justified in law or fact. The Commission is no longer legally bound to set depreciation rates for incumbent LECs. The Telecommunications Act of 1996 ("1996 Act") amended Section 220(b) of the Act to give the

¹ Petition for Forbearance of the United States Telephone Association, ADS 98-91 (filed Sept. 21, 1998) ("*USTA Petition*"), citing 47 U.S.C. § 160(c).

Commission discretion over whether to prescribe or otherwise regulate depreciation rates.²

Further, the Commission has eliminated the sharing mechanism under its price cap regulatory program, which was previously cited by the Commission as the major justification for retaining depreciation regulation of price cap LECs.³ Finally, forbearance from depreciation regulation of price cap LECs would be consistent with the requirements of Section 10 of the Act and would serve the public interest.⁴ Therefore, USTA asks the Commission to forbear from enforcing its depreciation rules effective January 1, 1999.⁵

On October 14, 1998, the Commission issued its *Depreciation NPRM* proposing to reduce or streamline its existing depreciation prescription process.⁶ Specifically, the Commission proposes to permit summary filings, to eliminate the prescription of depreciation rates for incumbent LECs (provided that the carrier uses depreciation factors within a range specified by the Commission), and to eliminate salvage from the depreciation process.⁷ The Commission also seeks comment on whether it should permit price cap LECs to set their own depreciation rates if they waive the automatic low-end adjustment.⁸ Finally, the Commission identifies instances in

² See *USTA Petition* at 4, citing 47 U.S.C. § 220(b).

³ See *id.* at 7.

⁴ See *id.* at 10-18.

⁵ *Id.* at 18-19.

⁶ See *1998 Biennial Regulatory Review — Review of Depreciation Requirements for Incumbent Local Exchange Carriers*, CC Docket No. 98-137, *Notice of Proposed Rulemaking*, FCC 98-170 (rel. October 14, 1998) (“*Depreciation NPRM*”).

⁷ *Id.* at ¶ 4.

⁸ *Id.*

which it believes it must rely upon depreciation regulation and seeks suggestions for conditions that would eliminate the need for depreciation regulation in such instances.⁹

As discussed below, U S WEST urges the Commission to exercise its authority under Sections 11 and 220(b) of the Act to eliminate depreciation regulation for price cap LECs.¹⁰ With “no sharing” price cap regulation, increasing competition, and rapidly changing technology there is no justification for denying price cap LECs the flexibility to set their own depreciable lives and amortization periods in accordance with generally accepted accounting principles (“GAAP”).

Alternatively, U S WEST submits that the Commission must grant USTA’s petition and forbear from regulating the depreciation and amortization practices of LECs subject to price cap regulation. The *USTA Petition* clearly demonstrates that forbearance from depreciation regulation of price cap LECs is required under Section 10 of the Act.

II. DEPRECIATION REGULATION SHOULD BE ELIMINATED

The instant review of the Commission’s depreciation regulations is part of the Commission’s biennial review of its regulations mandated by Section 11 of the Act. Section 11 requires the Commission, in every even-numbered year beginning in 1998, to review its regulations applicable to telecommunications carriers to “determine whether any such regulation is no longer necessary in the public interest as the result of meaningful competition between

⁹ See *id.* at ¶¶ 6, 8.

¹⁰ 47 U.S.C. § § 161 and 220(b).

providers of such service.”¹¹ The Commission is *required* to “*repeal or modify any regulation it determines to be no longer necessary in the public interest.*”¹²

As discussed below, the current depreciation rules for price cap LECs are vestiges of traditional rate-of-return regulation which no longer serve the public interest. Consequently, U S WEST submits that the Commission must modify or repeal its depreciation rules as required by Section 11 of the Act.

A. Depreciation Regulation of Price Cap LECs is no Longer Justified

The Commission has long recognized that price cap regulation greatly reduces the need for regulatory scrutiny of a carrier’s depreciation rates by severing the direct link between costs and prices.

Price cap regulation allows [the Commission] to reduce the level of scrutiny applied to data submitted by carriers to support their proposed rates by shifting the regulatory focus from carrier costs to prices charged ratepayers. Because price cap regulation prevents carriers from automatically recouping increased depreciation expense from ratepayers, carriers have less incentive to seek depreciation rates that are not representative of actual plant consumption. Moreover, . . . carriers are not routinely allowed to pass along increased depreciation expense through tariffed rates to ratepayers¹³

Congress has also recognized that current market conditions including price cap regulation and developing competition, greatly reduce the need for depreciation regulation. To that end, the 1996 Act amended Section 220(b) of the Act to give the Commission discretion

¹¹ *Id.* § 161(a).

¹² *Id.* § 161(b) (emphasis supplied).

¹³ *Simplification of the Depreciation Prescription Process*, 8 FCC Rcd. 8025, 8033-34 ¶ 20 (1993) (footnotes omitted).

over whether to continue prescribing LEC depreciation rates. The legislative history of the 1996 Act provides that the amendment to Section 220(b):

repeals the current requirement that the Commission set depreciation rates for common carriers, thus allowing the Commission flexibility to assess whether doing so would serve the public interest.¹⁴

Indeed, the only reasons the Commission was originally able to offer for retaining depreciation regulation in the face of price cap regulation were the sharing mechanism incorporated in the price cap model and the lack of significant competition.¹⁵ In the Commission's view, the sharing mechanism created incentives for LECs to seek depreciation rates that are not representative of actual plant consumption.¹⁶

The Commission ultimately abolished the sharing mechanism in 1997 thereby eliminating the principal rationale for maintaining depreciation regulations.¹⁷ Furthermore, as the telecommunications industry rapidly transitions to a competitive market, market forces rather than regulation will provide sufficient safeguards to eliminate any need for Commission depreciation regulation. As the Commission has recognized:

¹⁴ H.R. Conf. Rep. 458, 104th Cong., 2d Sess. at 186 (January 31, 1996).

¹⁵ 8 FCC Rcd. at 8033-34, n.28. Under the sharing mechanism, price cap LECs were required to "share" earnings above specified rates-of-return with their access customers by lowering the maximum rates that the LECs could charge during the next year.

¹⁶ *Id.* at 8033 ¶ 20.

¹⁷ *Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, 12 FCC Rcd. 16642, 16649 ¶¶ 10-11 (1997).

The telecommunications industry is evolving, and this evolution may well require us to revise our prescription methods, or possibly discontinue depreciation rate prescriptions altogether.¹⁸

In short, the legal and factual underpinnings of the Commission's regulation of price cap LECs' depreciation rates have been swept away.

B. Depreciation Regulation Does Not Serve Other Regulatory Purposes

Apparently recognizing the demise of the original rationale for maintaining depreciation regulation, the *Depreciation NPRM* offers new justifications for continuing depreciation regulation of price cap LECs. Specifically, the Commission states that a carrier's depreciation remains significant for: (1) calculating low-end adjustments; (2) recalculating the productivity factor; (3) making an exogenous cost determination; (4) calculating the Base Factor Portion; and (5) the cost support showing required to support an Actual Price Index higher than the Price Cap Index.¹⁹ In addition, the Commission states that depreciation factors are important elements of calculating forward-looking costs for universal service purposes and for certain state commission purposes.²⁰

U S WEST submits that depreciation regulation is *not* necessary to support any of these regulatory activities. As discussed below, the Commission has failed to show any circumstance in which it cannot rely on depreciation rates selected by LECs in accordance with GAAP. Indeed, the new rationale presented in the *Depreciation NPRM* appears to be offered solely in a

¹⁸ *Id.* at 16671 ¶ 65.

¹⁹ *Depreciation NPRM* at ¶ 6.

²⁰ *Id.*

post hoc effort to rationalize continuing an outdated, costly, and time consuming regulatory program.

With regard to the low-end formula adjustment, U S WEST recognizes that low-end adjustment is the only remaining link between reported costs and prices for price cap LECs. Simply put, it is conceptually possible that a carrier could select depreciation lives and amortization periods that would cause its earnings to go below the low-end formula adjustment level allowing the carrier to increase its rates. As a practical matter, however, this circumstance is not likely to arise. Shareholder obligations as well as developing competition in the market place strictly limit a LEC's ability to improperly benefit from the low-end adjustment by manipulating depreciation rates. Further, if such a situation did arise, the Commission would remain free to review the LEC's depreciation and amortization parameters and rates for reasonableness. In other words, LECs' depreciation practices would continue to be subject to review on an as-needed basis, eliminating the need to prescribe depreciation rates.

Similarly, while the Commission has previously chosen to use prescribed depreciation rates to recalculate the productivity factor under price cap regulation, its decision to do so was only a "limited finding[.]"²¹ Further, there is no evidence that a Commission prescribed depreciation rate would serve this purpose better than a depreciation rate selected by the carrier. Indeed, the Commission specifically stated that it would revisit its productivity factor calculations should LECs be permitted to set their own depreciation rates.²²

²¹ 12 FCC Rcd. at 16671 ¶ 65.

²² *Id.*

Moreover, the Commission is simply wrong in characterizing depreciation rates as significant for purposes of exogenous cost determinations. Cost changes due to changes in depreciation rates are treated as endogenous.²³ Elimination of depreciation regulation for price cap LECs will have no effect on the endogenous treatment of such costs. Further, while depreciation rates are a factor in certain exogenous cost pass throughs, the difference between the depreciation rates selected by the carrier and those prescribed by the Commission would have no significant incremental impact on such costs.

With regard to the Base Factor Portion calculation, U S WEST notes that the Commission requires LECs to provide detailed explanations of the “data, assumptions, and methodology” used to derive the Base Factor Portion revenue requirement projections.²⁴ Permitting carriers to set their own depreciation rates would not change this requirement. Consequently, the Commission would be able to review the reasonableness of a carrier’s chosen depreciation rates in this context. Thus, establishing a depreciation rate by regulatory *fiat* is unnecessary.

Similarly, the Commission would be able to review a carrier’s depreciation rates when that carrier files its required cost support if its Actual Price Index is higher than its Price Cap Index.²⁵ Thus, permitting carriers to select depreciation rates would not alter or undermine the Commission’s ability to evaluate a carrier’s cost support in such circumstances.

²³ See *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd. 6786, 6809 ¶ 182 (1990) (“*LEC Price Cap Order*”), *erratum*, 5 FCC Rcd. 7664 (CCB 1990), *modified*, 6 FCC Rcd. 2637 (1991); *aff’d sub nom. National Rural Telecom Ass’n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

²⁴ *1997 Annual Access Tariff Filings*, 12 FCC Rcd. 11417, 11429 ¶ 27 (1997).

²⁵ See 47 C.F.R. § 61.49(e); 61.46(c), and 61.47(d).

With regard to universal service, U S WEST believes that prescribed depreciation rates are inappropriate for use in calculating forward looking economic costs for high cost support purposes. Forward looking cost studies should reflect market values and conditions rather than conditions prescribed by the Commission. Depreciable lives and amortization rates chosen by the carriers will be far more likely to reflect market conditions and are therefore more realistic and reasonable for use in forward looking cost studies.

Finally, while some state commissions look to Commission-prescribed depreciation for certain purposes, there is no requirement that they continue this practice.²⁶ State commissions are free to develop — and have developed — depreciable lives and amortization periods for their own purposes.²⁷ Thus, federal depreciation regulation is *not* critical for state commission regulatory purposes.

In sum, the Commission has offered no sound rationale for continuing depreciation regulation for price cap LECs.

C. Permitting LECs to set Their Depreciation Rates Would Serve the Public Interest

In light of the above, U S WEST submits that the Commission should revise its rules to permit carriers to set depreciation lives, amortization periods and rates based upon each carrier's particular circumstances all in accordance with GAAP. Such action is reasonable and

²⁶ Indeed, each of the 14 states in which U S WEST operates has established depreciable lives that are different than those prescribed by the Commission. In addition, all 14 states have at least one depreciable life that is below the Commission-prescribed ranges.

²⁷ *Louisiana Public Service Comm'n v. FCC*, 476 U.S. 355, 375-76 (1986) (finding that under Section 2(b) of the Act, states retain jurisdiction over depreciation charges for intrastate telephone plant and equipment).

would serve the public interest. Depreciable lives that are no shorter than the economic lives determined for use on a company's external financial reporting books should be permissible. These books are required to meet GAAP standards which ensure that readers of the financial statements have information which clearly and accurately reflects the nature of the financial transactions undertaken by the company.

As demonstrated above, the depreciation rules no longer serve any useful purpose. The rules do, however, impose significant administrative burdens upon price cap LECs as well as the Commission with little or no benefit to the public. While the streamlining proposed in the *Depreciation NPRM* will alleviate somewhat the administrative burden on the Commission, it will provide little relief for price cap LECs — carriers will have to develop and retain voluminous records and work papers to support the Commission requirement that the selected depreciable lives are "consistent with their operations," even if the filings themselves are summary. In U S WEST's view, this filing requirement is completely unwarranted as it relies solely on historical evidence.

In addition, significant incremental work would be required by the Commission to establish reasonable economic life ranges. The Commission has proposed an economic life range for digital switching equipment which has a low end that is extremely out-of-date.²⁸ Moreover, there are assets other than digital switching which have inappropriate low end ranges. Over the years, many parties have filed evidence with the Commission showing that the Commission's prescribed depreciable lives and economic life ranges are inconsistent with the

²⁸ See *Depreciation NPRM* at ¶ 11. In that regard, U S WEST submits that the low end of the range for digital switching should be in the 8-year time frame rather than the 13-year period suggested by the Commission.

economic lives used for external reporting purposes by unregulated companies and regulated companies. State commissions are also utilizing economic life ranges that are lower than those prescribed by the Commission.²⁹ In short, the Commission would have to revisit the economic life ranges for *all* assets. U S WEST submits, therefore, that the Commission should refrain from holding the price cap LECs to depreciable lives that are set at unrealistic and unsupportable levels and, instead permit LECs to set their own depreciation rates.

Permitting LECs to set depreciation rates would make these determinations more realistic in that LECs would have greater freedom to take into account the many countervailing influences in the financial and business environment. Such competing influences ensure that a company will establish economic lives that are financially meaningful and within appropriate ranges. Such a result will improve the efficiency of the price cap LECs' operations and enhance their competitive position thereby better enabling them to bring the benefits of competition to the ratepayers.

Further, as Arthur Andersen, LLP notes in its November 10, 1998 Supplement to its Position Paper on Accounting Simplification in the Telecommunications Industry, the Bell Operating Companies and GTE currently experience a true depreciation reserve deficiency of approximately \$34 billion.³⁰ Permitting LECs the flexibility to set economic depreciable lives and amortization periods will not eliminate this existing reserve deficiency. It would, however, prevent such enormous reserve deficiencies from developing on a going-forward basis.

²⁹ See *supra* text at n.26.

³⁰ See Supplement to July 15, 1998 Position Paper, "Accounting Simplification in the Telecommunications Industry," at 17, CC Docket Nos. 98-81, 98-117, 96-150, and ASD File No. 98-64 (filed November 10, 1998).

Moreover, elimination of Commission depreciation regulation would *not* enable carriers to “game” their depreciable lives and amortization periods to unduly increase revenue at the expense of ratepayers. As noted above, a company’s external financial reporting books are required to meet GAAP standards which ensures that the depreciable lives reflected in the books are reasonable and appropriate. Indeed, as Arthur Andersen describes in its November 10, 1998 Supplement, GAAP is characterized by: relevance; reliability; neutrality; comparability; consistency; materiality; costs and benefits.³¹ These attributes serve to protect all users of financial statements prepared in accordance with GAAP, including shareholders, regulators, financial analysts and creditors.³²

In addition, a company’s compliance with GAAP standards is assured through annual audited financial statements filed with the Securities and Exchange Commission (“SEC”). In addition to the oversight inherent in GAAP compliance, publicly-traded companies such as the price cap LECs are subject to additional SEC regulation regarding financial records and disclosure, stock exchange listing requirements, and to external audit on an annual basis. These ongoing oversight mechanisms ensure that a company will establish economic lives that are comparable with those of other similarly-situated companies and are within appropriate ranges for financial reporting purposes.

For the reasons set forth above, U S WEST urges the Commission to exercise its authority under Sections 11 and 220(b) of the Act to eliminate depreciation regulation for price

³¹ Arthur Andersen Supplement at 12.

³² *Id.* at 12-13.

cap LECs. Price cap LECs should be granted the flexibility to set their own depreciable lives and amortization periods in accordance with GAAP.

III. THE COMMISSION SHOULD FORBEAR FROM DEPRECIATION REGULATION OF PRICE CAP LECs

If the Commission determines not to repeal depreciation regulation under Sections 11 and 220(b) of the Act, U S WEST submits that the Commission must grant the *USTA Petition* and forbear from regulating the depreciation and amortization practices of LECs subject to price cap regulation. Specifically, the Commission must forbear from enforcing Sections 32.2000(g), (h), and 43.43 of its rules.³³

The 1996 Act granted the Commission expanded forbearance authority. Specifically, the new Section 10(a) of the Communications Act *requires* the Commission to forbear from applying any regulation or provision of the Act to a class of telecommunications carriers in any of their geographic markets if:

- (1) enforcement of such regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or telecommunications service are just and reasonable and are not unjustly or unreasonably discriminatory;
- (2) enforcement of such regulation or provision is not necessary for the protection of consumers; and
- (3) forbearance from applying such provision or regulation is consistent with the public interest.³⁴

³³ 47 C.F.R. §§ 32.2000(g), (h) and 43.43.

³⁴ 47 U.S.C. § 160(a)(1)-(3).

In determining whether forbearance is consistent with the public interest, the Commission must “consider whether forbearance . . . will promote competitive market conditions, including the extent to which such forbearance will enhance competition among providers of telecommunications services.”³⁵ The *USTA Petition* demonstrates that this new Section 10 of the Act compels the Commission to forbear from imposing depreciation regulation upon price cap LECs.

First, USTA shows that depreciation regulation is not necessary to ensure that price cap LECs’ charges, practices, classification, regulation, or other activities are just and reasonable and are not unjustly or unreasonably discriminatory.³⁶ U S WEST and the other large incumbent LECs are subject to price cap regulation rather than the rate-of-return regulation contemplated by the existing depreciation rules.³⁷ Under price cap regulation, rates are no longer based upon cost-of-service plus a return on capital investment. In other words, rates are regulated without regard to the costs incurred and the plant investment utilized to provide such services. Thus, regulation of depreciation rates is no longer critical to ensuring that a price cap LEC’s rates are just and reasonable.

Further, as discussed above, there are numerous regulatory safeguards other than Commission depreciation rules which ensure a price cap LEC’s rates and practices are reasonable and comparable with those of other similarly situated companies.³⁸ Indeed, as USTA points out,

³⁵ *Id.* at § 160(b).

³⁶ *USTA Petition* at 10-14.

³⁷ *See LEC Price Cap Order*, 5 FCC Rcd. 6786.

³⁸ *See supra* text at 11-12; *USTA Petition* at 13.

the growing competitive market disciplines a carriers rates and practices even more effectively than the existing “command and control” regulations.³⁹ Thus, strict rules for depreciable lives and amortization periods are not necessary to ensure that price cap LECs’ rates and practices are just and reasonable and are not unjustly or unreasonably discriminatory.

Second, the *USTA Petition* demonstrates that depreciation regulation is not necessary to protect consumers.⁴⁰ As discussed above, price cap regulation severs the relationship between costs and rates thereby rendering depreciation regulation effectively irrelevant to consumer protection. Further, there are significant regulatory safeguards other than Commission depreciation rules which adequately protect the consumers interests.⁴¹ Finally, the ongoing development of competition in the telecommunications marketplace itself will ultimately protect consumers more efficiently than any regulatory program.

Third, the *USTA Petition* demonstrates that forbearance from enforcing depreciation rules against price cap LECs would serve the public interest.⁴² U S WEST highlights some of the benefits that would arise from allowing LECs to set their own depreciable lives and amortization periods above.⁴³

³⁹ *USTA Petition* at 14.

⁴⁰ *Id.* at 14-16.

⁴¹ *Id.* at 15-16.

⁴² *Id.* at 16-18.

⁴³ *See supra* text at 11.

In sum, the *USTA Petition* demonstrates that forbearance from depreciation regulation of price cap LECs is required under Section 10 of the Act. U S WEST therefore requests that the Commission expeditiously issue an order forbearing from such regulation.

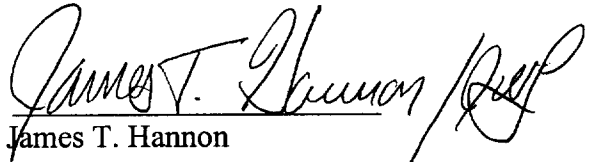
IV. CONCLUSION

For the foregoing reasons, U S WEST submits that the Commission should exercise its authority under Sections 11 and 220(b) of the Act to eliminate depreciation regulation for price cap LECs. There is simply no justification in law or fact for continuing to deny price cap LECs the flexibility to set their own depreciable lives and amortization periods in

accordance with GAAP. In the alternative, the Commission should forbear from regulating the depreciation and amortization practices of LECs subject to price cap regulation.

Respectfully submitted,

U S WEST, Inc.

By: 
James T. Hannon

U S WEST, Inc.
Suite 700
1020 19th Street, N.W.
Washington, D.C. 20036
(303) 672-2860

Its Attorney

Of Counsel,
Daniel L. Poole
U S WEST, Inc.

Kathryn A. Zachem
J. Wade Lindsay
Wilkinson, Barker, Knauer & Quinn LLP
2300 N Street, N.W.
Washington, D.C. 20037
(202) 783-4141

Date: November 23, 1998